Market volatility update – Giving credit where credit is due

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A great flood of liquidity: In our article titled The Bridge to the Future, we documented the historic intervention of fiscal and monetary policy. The goal of these measures was to flood the economy and financial system with liquidity to fill the void left by the Covid-19 shutdown. As the initial panic has passed and the reality of the economic situation is setting in, let’s assess the reaction to these liquidity measures. While it will take more time to form an opinion on the full effect from the stemming of defaults and downgrades, we can look at the reaction of credit spreads now for an initial indication.

A lid on spreads: In the early stages of the pandemic, credit spreads, which had been hovering near all-time lows, widened significantly. The concern over defaults and the sell at all costs to raise liquidity caused a surge in credit spreads. This widening, across high yield and investment grade alike, had potential for a negative contagion effect across capital markets. However, as shown below, spreads have stabilized and reversed course over the past week.

Source: Federal Reserve Economic Data (FRED)

This reversion provides extremely positive tailwinds for the stabilization and ultimate recovery of the global economy.
What does this mean for fixed income investors: After years of low rates, investors who preferred a more conservative allocation on the capital market line where finally being rewarded as interest rates rose throughout 2018. The reversion in central bank policy in early 2019 rewarded duration despite the low absolute level of interest rates and low relative spreads. Now that spreads have widened, fixed income investors are receiving a greater premium across the risk spectrum. From investment grade to high yield, each new dollar allocated is being invested at this higher premium. This enables investors to enhance their return potential per unit of risk.